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**Statement by Mr. Bevilaqua, Ms. Mahabir, and Mr. Fuentes on Turkey
(Preliminary)
Executive Board Meeting
January 18, 2023**

We thank staff for the set of reports and Mr. Mert and Mr. Akben for their helpful statement. After experiencing an impressive recovery from the pandemic shock in 2021, the Republic of Türkiye continued exhibiting strong growth in 2022. Nonetheless, challenging external conditions influenced by the war in Ukraine and the remnants of the pandemic have exacerbated existing vulnerabilities, accelerating exchange rate depreciation, and pushing inflation to record highs while slowing down growth and widening the current account deficit. Against this background, we take note of the authorities' new growth strategy and their differences in views with staff regarding the appropriate policy response under the current circumstances and the near-term economic outlook. In this regard, despite the recent slowdown in inflation and credit growth, we see merit in staff recommendation that the overall policy mix remains too stimulative. Therefore, we encourage the authorities to recalibrate their policy strategy to help restore macroeconomic stability, address rising vulnerabilities, and rebuild policy buffers.

A contractionary monetary policy stance is urgently needed to control inflation and re-anchor expectations. Inflation accelerated sharply in 2022 imposing a large cost to the economy, particularly on low-income households and small and medium enterprises (SMEs). Maintaining low interest rates under these circumstances is contributing to the high inflation rate and raising the policy cost of re-anchoring inflation expectations in the future. In addition, this policy stance may be exacerbating depreciating pressures on the exchange rate and increasing the need for large and more frequent foreign exchange interventions from falling reserves. In this regard, we associate ourselves with staff that a sizeable increase in interest rates is warranted, accompanied by a well-communicated and credible re-commitment to the central bank's price stability target.

Despite the challenging circumstances, we welcome the authorities' commitment to fiscal discipline. Their approach has helped preserve fiscal space and keep public debt low and sustainable under the scenarios considered in the Debt Sustainability Analysis. While government spending is expected to pick up in the coming months, we take note that the authorities have recognized some of the prevailing risks to public finances in the 2023 budget. However, more attention is needed on fiscal risks emanating from the FX-protected deposits scheme, the public private partnerships (PPPs), and state-owned banks to avoid further spending pressures and potential financing constraints.

Regarding the financial system, the Financial Sector Stability Assessment report presents a mixed picture with progress in some areas and lingering challenges. We commend the authorities for the progress made since the previous Financial Sector Assessment Program on financial inclusion and cybersecurity, both supported by a rising digitalization trend and a strengthening legal framework. At the same time, the growing use of macroprudential policies, banking regulations, and systemic liquidity-management measures to tighten financial conditions and direct credit to selected sectors may be exacerbating operational and credit risks to the financial sector. Therefore, we concur with staff that a carefully sequenced phasing out of the complex set of macrofinancial and regulatory measures is required to limit the buildup of financial sector vulnerabilities and realign incentives to safeguard financial stability. It is also paramount to take action to reduce the risk emanating from the links between the financial sector and the government balance sheet via state-guaranteed FX-protected deposits and continue to improve AML/CFT governance framework to address the FATF grey listing.

Finally, renewed focus on structural reforms is warranted to foster more inclusive growth, restore macroeconomic stability, and strengthen the policy framework. We encourage the authorities to systematically turn their focus to implement a well-sequenced structural reform agenda to boost potential growth, increase productivity gains and address weaknesses in the macroeconomic policy framework. Priorities should include reforms to strengthen the independence and financial autonomy of the central bank, increase fiscal transparency and help limit quasi-fiscal risks, improve the regulatory environment, and boost human capital investment and labor market flexibility inclusive of higher levels of female participation.